

IDAHO OUTLOOK

NEWS OF IDAHO'S ECONOMY AND BUDGET

STATE OF IDAHO

DIVISION OF FINANCIAL MANAGEMENT

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What is a conundrum? According to the *Microsoft Encarta College Dictionary* it is "something puzzling, confusing, or mysterious." According to Alan Greenspan it is the perfect word to describe why long-term interest rates have remained low despite rising short-term rates. The nation's central bank has been raising its bellwether federal funds rate target in 25 basis-points increments since June 30, 2004 to its current rate of 3.00%. In contrast to these increases, 10-year U.S. Treasury bill and conventional mortgage rates are lower now than they were last July. This issue of the *Idaho Outlook* investigates the current interest rate enigma that has many economists shaking their heads.

An old joke helps explain the connection between short- and long-term interest rates. A man dies and stands in line at the Pearly Gates. In order to enter the gates he must present his IQ to St. Peter. When he divulges his very low IQ, St. Peter assumes he is an economist and asks him where interest rates are headed. Essentially, long-term rates are a guess of what interest rates will be at some future date. In his article titled, "Can Monetary Policy Influence Long-term Interest Rates?" Dr. Óscar Jordá develops a simple model that shows there is a relationship between the Federal Reserve's actions and long-term interest rates. The correlation between short- and long-term interest rates is especially strong when the federal funds rate is changing gradually. Given the Federal Reserve's current policy, longer-term rates should be rising. But they are not. What gives?

Economists at Global Insight, a leading economic forecasting firm, believe the most compelling reason long-term rates have not budged is the absence of any worldwide inflationary pressures. The creditability of the Federal Reserve and

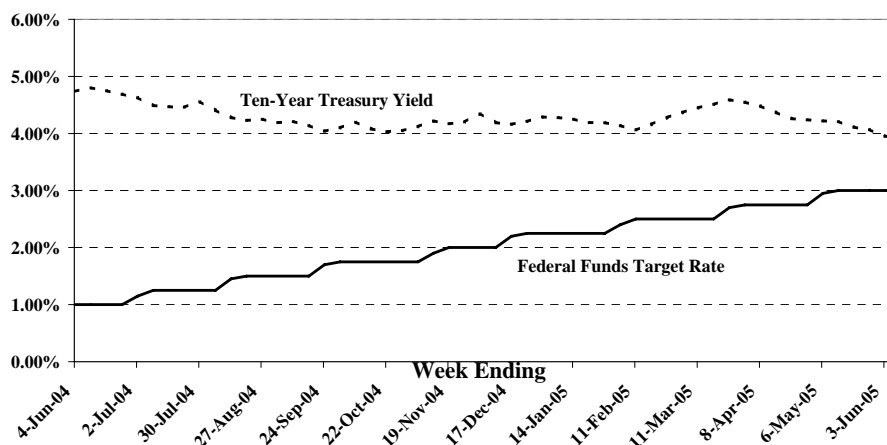
other central banks around the globe in keeping inflation under control has been an important factor sustaining this low-inflation environment. Given global central banks recent victories against inflation, financial markets are betting inflation will not be a problem in the future. Therefore, they also assume central banks will not soon be aggressively raising their short-term interest rates. Thus, the low long-term interest rates. Put another way, low long-term rates are simply a sign of the Federal Reserve's success in controlling inflation.

Another factor keeping the lid on long-term interest rates is the global savings surplus. Trade patterns over recent years have left many emerging countries flush with cash. This cash must be invested somewhere, and modern financial markets allow this money to be invested anywhere in the world. This cash will land in the country that has the highest expected return. It should be pointed out that interest rates are important factors, but they not the only factors. The risk on returns must also be considered. For example, an emerging country may have a higher interest rate

compared to an industrialized country, but the rate advantage could easily be wiped out if the country decided to devalue its currency or default on its bonds. The U.S. is one of the world's safest havens for investing cash. In addition, among developed nations, the U.S. offers relatively high long-term interest rates. As such, the U.S. has been a magnet for these cash surpluses, which are keeping U.S. long-term interest rates low. It should be pointed out, that unlike 2003 and 2004, purchases by foreign central banks have played no role in the recent fall in long-term interest rates. In fact, since the beginning of this year all the (net) purchases of U.S. Treasury bonds and notes have been made by private investors.

Do these two reasons completely explain why long-term rates have remained low while the Federal Reserve has been raising its bellwether short-term rate? Probably not. It is more likely there are other factors, many of which are impossible to identify or measure. Given this, economists must learn to be comfortable with their latest conundrum.

Average Weekly Interest Rates



Source: The Federal Reserve Board

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General Fund Update

As of May 31, 2005

<u>Revenue Source</u>	<u>\$ Millions</u>		
	FY05 Executive Estimate ³	DFM Predicted to Date	Actual Accrued to Date
Individual Income tax	974.5	917.9	969.7
Corporate Income tax	120.6	102.2	119.8
Sales Tax	933.4	852.4	869.8
Product Taxes ¹	22.4	20.5	20.7
Miscellaneous	105.9	56.1	69.4
TOTAL GENERAL FUND²	2,156.9	1,949.0	2,049.4

¹ Product Taxes include beer, wine, liquor, tobacco and cigarette taxes
² May not total due to rounding
³ Revised Estimate as of January 2005

General Fund revenue once again exceeded expectations in May, but several key indicators have settled back to a more "predicted" level of performance. May's gain of \$11.6 million is due primarily to lower-than-expected refunds in the individual income tax and stronger-than-expected interest earnings in the miscellaneous revenue category. The year-to-date excess has broken the 100-million dollar mark, and stands at \$100.4 million. Over one-half of the year-to-date excess is in the individual income tax, and about one-third is split equally between the corporate income tax and the sales tax. The miscellaneous revenue category contributes about thirteen percent of the year-to-date excess.

Individual income tax accounted for \$9.5 million of May's excess

revenue. Refunds were \$10.3 million lower than predicted and filing payments were \$0.4 million higher than predicted, but withholding collections were \$1.5 million lower than expected. May is only the third month this fiscal year that withholding has underperformed expectations, but withholding collections are still \$5.0 million ahead of expectations on a year-to-date basis.

Corporate income tax was \$2.2 million lower than expected for the month. It is now \$17.7 million higher than expected for the year to date. May's weakness was primarily due to \$0.9 million less in filing payments than expected, \$0.5 million less in estimated payments, and \$0.3 million more in refunds than were expected.

Sales tax was \$0.7 million higher than expected for the month. It is now \$17.4 million higher than expected for the year to date. May's performance, while positive, is the second weakest month of the current fiscal year (October was only \$0.5 million higher than expected).

Product taxes were less than \$0.1 million lower than expected in April, and are now \$0.2 million higher than expected for the fiscal year to date. Total miscellaneous revenue was \$3.6 million higher than expected for the month of May (almost entirely due to strong interest earnings) and is \$13.3 million higher than expected for the fiscal year to date (\$7.4 million is in unclaimed property and \$4.1 million is in the insurance premium tax).